Jilted shareholders rethink faith in stocks

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BYLINE: By Janet Kidd Stewart, Tribune staff reporter.

America's torrid love affair with stocks faces its toughest test in a generation.

Punctuated by terror, this month's dramatic deepening of the 18-month-long slide in the stock market undermines the ambitious outlook that once promised to make this country a nation of shareholders. Ideas spawned in the roaring bull market of the '90s, such as investing Social Security money in the stock market, appear headed for the shelf. New regulations may be in the offing, particularly for corporate pension plans that have seen once-swollen equity portfolios dwindle, and the dramatic shift of thousands of retirement programs from professionally managed plans with guaranteed benefits to individually run 401(k) accounts may start to be reversed. Boards of non-profit organizations--and households, surely--are already rethinking the wisdom of pouring so much money into stocks.

During the '90s, the number of U.S. households owning stocks swelled by more than 10 million as the market posted unprecedented gains. Now, with many of those profits evaporated, the recriminations have already started: Investors are suing the pros who recommended dot-com stocks. Congress has been looking at those analysts' conflicts of interest. New rules that require public companies to disclose important financial information equally are getting a new look. In addition, the longtime practice of shorting stocks--which allows investors to profit when shares fall--could be in for new scrutiny if it turns out that terrorists or their supporters managed to profit from the Sept. 11 attacks.

Even before the tragedy, noted John Rekenthaler of Chicago mutual fund tracker Morningstar Inc., the "cult of equities" was eroding.

"This is a historic turning point," he said. "It will certainly slow our growth rate."

Other market experts agreed.

"Every generation gets a scare from the stock market," said Laszio Birinyi, a market research expert. "It will be another generation before there is tremendous interest again. People found out Wall Street goes two ways."

It was great while it lasted, though. Armed with a chatty new tool called the Internet that offered huge amounts of real-time stock data and whole cable TV channels largely devoted to equity investing, Americans' social conversations turned to business like never before.

This love affair even outlasted the initial dot-com bust, not succumbing until the economic data got really bad. Even then, though, there was hope.

But the attacks and the accompanying fear and uncertainty about the future drew all that giddiness to a close, finally flushing the heady mood of investors.

Now, many predict, come the real recriminations.

New look at retirement plans

Political strategists are saying that even advocates of Social Security privatization acknowledge the idea of a market-based system for the government program--a prominent portion of President Bush's election campaign--is, at best, on hold.

"We had a 5 1/2-year run that was so strong it lulled people into believing we could have higher returns and stability. That's over," said noted University of Virginia politics professor Larry Sabato.

Privatization's strongest proponents remain hopeful. Cato Institute officials will be on Capitol Hill on Monday to promote it, and the group's president, Edward Crane, is speaking on the topic in Chicago on Tuesday.

"The whole thing was going to be put off until 2003 anyway," he said, adding that the key benefits of a private system--letting heirs inherit funds and allowing private citizens, rather than the government, to make investment decisions--will win out in the end. "You don't have to put money in stocks," he said. "The issue is ownership."

But U.S. Rep. Jan Schakowsky, already a foe of injecting market volatility into Social Security, believes opponents of the idea are in full control in the wake of the terrorist attacks and market meltdown.

"It was never a good idea, and it's a worse idea now," the Evanston Democrat said. She said she also believes political leaders will begin reviewing other points of vulnerability for Americans' retirement, such as pensions and 401(k) accounts.

"The precariousness of our retirement framework has been underscored by this drop in the market," Schakowsky said.

American workers had 72 percent of their 401(k) plans invested in stock mutual funds or their own company stock in 1999, according to the Employee Benefits Research Institute in Washington. Also that year, the group reports, mutual funds accounted for 49 percent of individual retirement accounts, up from 8 percent in 1981.

A congressional bill scheduled for markup this week would liberalize the advice employers can give to workers about retirement plan choices, a step detractors say is fraught with conflicts of interest.

"If people are truly getting objective advice, they will be told they have too high a concentration of employer stock," said David Certner, director of economic issues for AARP.

Without legislative attention, workplace experts predict, a flurry of lawsuits awaits.

Cowboy shareholders investing online aren't the only ones with vulnerable portfolios. Churches, museums and scores of other charities jumped on the equity bandwagon in the last several years to boost their endowments; now, many of them are turning to their financial advisers and asking why so much was allocated to equities. Experts say charities, like individuals, had boosted the equity portion of their portfolio to well up more than 60 percent in the market heyday.

King McGlaughon, who manages 32,000 non-profit organizations' money for Merrill Lynch, acknowledges he has taken some challenging phone calls in recent days from clients second-guessing their heavy allocation of assets in stocks. Charities' donations are suffering because of the economic downturn, and their extensive stock holdings may drastically shrink the amount of money available to provide services and plan for the future.

"But the basic rules of financial management haven't changed," McGlaughon said. "The long-term picture remains unchanged. We're asking people to not make immediate Day One decisions that have long-term impact. It is a difficult conversation, and you can go too far by being overly optimistic."

Indeed. Heady optimism is greeted today with a much more skeptical eye from customers, though thus far there has been little new public outcry for tougher market regulations.

Options activity scrutinized

It may be too early for that, though experts say the voices will grow louder if the bear market drags on. And more will be learned from investigations into put option activity at the Chicago Board Options Exchange just before the Sept. 11 tragedy. Depending on the outcome, new calls for curbs on short selling could mount, said Morningstar's Rekenthaler.

"In a war effort everything is open to being changed if the country needs it," he said. "Maybe Americans should not be profiting from bad news about the country.

"It's still early, and it might be argued that hampering the market creates an artificial effect that isn't good, either, but war is about sacrifice, and sacrificing some profit doesn't seem that [onerous] to me. I'd be for it, and I think Main Street would be too."

The securities industry is skilled at lobbying for its causes and fighting regulations it deems too strict, but previous market crises have spawned new regulations--from tighter margin restrictions and rules limiting the activities of commercial banks and investment bankers after the October 1929 crash to stock market circuit breaker rules that evolved from the October 1987 crash.

"Some of the lessons learned in the '87 crash are paying off here," said Robert Glauber, chief executive of the National Association of Securities Dealers Inc., an industry regulatory arm. Glauber, executive director of the Brady Commission task force that examined the 1987 market crash, cited increased capacity and coordination of circuit breaker rules between New York equity and Chicago derivative markets as two reasons for a relatively orderly sell-off in stocks after markets reopened.

No doubt, still, the industry stands ready to quash calls for rules it finds too restrictive. Chicago's derivative markets have often been targets, with politicians and others blaming them for an unhealthy volatility in the marketplace.

Merton Miller, the late University of Chicago Nobel economics laureate, was often called upon to counter such arguments. He argued, as do others, that derivatives mitigate risk rather than create it.

In a speech in July to the International Association of Financial Engineers, futures industry leader Leo Melamed acknowledged the battle futures markets face in times of stress.

"While detractors accused them of everything from the Black Plague to the 1987 stock crash ... one thing remained constant: They provided liquid pools of buyers and sellers in the management of risk," he said.

Clearly, though, the leaders of the securities markets and the companies trading on them are grappling with all of these questions--and more.

Concludes Rekenthaler: "The cult of equities has been broken."

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